COUNCIL OF THE EUROPEAN UNION

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LEGISLATIVE ACTS AND OTHER INSTRUMENTS

Subject:	COUNCIL RECOMMENDATION to Hungary with a view to bringing an end to the situation of an excessive government deficit

COUNCIL RECOMMENDATION

of …

to Hungary with a view to bringing an end to the situation of an excessive government deficit

THE COUNCIL OF THE EUROPEAN UNION,

Having regard to the Treaty establishing the European Community, and in particular Article 104(7) thereof,

Having regard to the recommendation from the Commission,

Whereas:

(1) According to Article 104 of the Treaty, Member States are to avoid excessive government deficits.

(2) The Stability and Growth Pact is based on the objective of sound government finances as a means of strengthening the conditions for price stability and for strong sustainable growth conducive to employment creation.

(3) The 2005 reform of the Stability and Growth Pact sought to strengthen its effectiveness and economic underpinnings as well as to safeguard the sustainability of the public finances in the long run. It aimed at ensuring that in particular the economic and budgetary background was taken into account fully in all steps in the excessive deficit procedure ("EDP"). In this way, the Stability and Growth Pact provides the framework supporting government policies for a prompt return to sound budgetary positions taking account of the economic situation.

(4) On 5 July 2004, the Council decided, in accordance with Article 104(6), that an excessive deficit exists in Hungary.

(5) Having decided on the existence of an excessive deficit in Hungary, the Council, in accordance with Article 104(7) of the Treaty and Article 3 of Council Regulation (EC) No 1467/97 of 7 July 1997 on speeding up and clarifying the implementation of the excessive deficit procedure[1], recommended on 5 July 2004 that the Hungarian authorities take action in a medium-term framework in order to bring the deficit below 3 % of GDP by 2008 in accordance with the path for deficit reduction as specified in the Council Opinion of 5 July 2004 on the convergence programme submitted in May 2004. On 18 January 2005, the Council, acting pursuant to Article 104(8) of the Treaty on a recommendation by the Commission, decided that Hungary had not taken effective action by the target date of 5 November 2004 in response to its recommendation, particularly since the deficit target for 2005 was expected to be missed by a sizable margin.

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[1] OJ L 209, 2.8.1997, p. 6.

(6) On 8 March 2005, upon a recommendation by the Commission, the Council adopted, in accordance with Article 104(7), a new recommendation to the Hungarian authorities to take action to bring the deficit below 3 % of GDP by 2008.[1] On 8 November 2005, the Council decided for the second time, pursuant to Article 104(8) on a Commission recommendation, that Hungary's action was inadequate. Thereby it notably took into account the fact that the deficit targets of 3,6 % of GDP in 2005 and of 2,9 % of GDP in 2006 (without the burden arising from the 1998 pension reform)[2] would be missed by a sizable margin and that the implementation of tax cuts starting from 2006 was contrary to the Council recommendation.

(7) On 10 October 2006, upon a recommendation by the Commission, the Council adopted, in accordance with Article 104(7), a third recommendation to the Hungarian authorities to take action to correct the excessive deficit. This recommendation extended the deadline for the correction of the excessive deficit to 2009 in view of the marked increase in the 2006 government deficit and reflected the Council opinion on the September 2006 adjusted update of the convergence programme, notably endorsing the authorities' new adjustment path. It envisaged a front-loaded deficit reduction, from the high starting position of 10.1 % of GDP in 2006 to 6,8 % of GDP in 2007, 4,3 % of GDP in 2008, and 3,2 % of GDP in 2009.

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[1] Having joined the Community on 1 May 2004, Hungary is a Member State with a derogation within the meaning of Article 122(1) of the Treaty, which means that it is to avoid excessive deficits but that Article 104(9) and Article 104(11) of the Treaty does not apply to it; further recommendations can only be addressed to Hungary on the basis of Article 104(7).

[2] These targets did not include the burden arising from the 1998 reform of the pension system since in December 2004 the Hungarian authorities decided to avail themselves of the decision by Eurostat of 23 September 2004 (Eurostat News Release No 117/2004) allowing the classification of second-pillar pension schemes inside the general government sector for a transitory period until the March 2007 notification. Using the most recent estimates of the pension reform contribution, these deficit targets including the pension reform burden would have been 5 % of GDP and 4,5 % of GDP, respectively.

In particular, the Hungarian authorities were recommended to limit the deterioration of the fiscal position in 2006, ensure a front-loaded and sustained substantial correction of the structural deficit, and swiftly implement the planned structural reforms. They were also recommended to bring the government gross debt ratio on a firm downward trajectory and to improve budgetary control by enhancing fiscal rules and strengthening the institutional framework. The Council recommendation welcomed the commitment of the Hungarian authorities in the September 2006 adjusted programme update to present semi-annual progress reports to the Commission and the Council until the abrogation of the EDP.

(8) In April 2007, the Hungarian Government submitted the first progress report on the implementation of its consolidation and reform programme. Taking into account this report, the Commission adopted a Communication in June 2007[1] concluding that Hungary had taken effective action by the deadline of 10 April 2007 regarding the recommendations of October 2006. Meanwhile, it underlined that the planned adjustment crucially hinged upon further specifying and implementing the structural reform plans in the field of public administration, health care, pensions and education as well as on reinforcing the budgetary framework. In its meeting of July 2007, the Council concurred with this assessment. In September 2007, April 2008 and November 2008 the Hungarian authorities submitted successive progress reports to the Commission and the Council. These reports were analysed and it was considered on all occasions that in view of the progress achieved in terms of fiscal consolidation, structural reform, and improvements in fiscal governance, no further steps in the EDP were necessary. In particular, this took into account that the deficit targets in 2007 and 2008 were outperformed (4,9 % of GDP and 3,4 % of GDP instead of 6,8 % of GDP and 4,3 % of GDP, respectively). At the same time, the debt-to-GDP ratio stabilised at around 66 % in 2007 until autumn 2008.

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[1] SEC(2007) 775.

(9) In its opinion of 10 March 2009 on the December 2008 update of the convergence programme, the Council concluded that, in spite of distinct improvements in its high imbalances, including the reduction in the budget deficit from 9,2 % of GDP in 2006 to below 3,5 % of GDP in 2008, Hungary had been particularly exposed to the financial crisis and thus had to limit the financing need of the government rather than stimulate the economy during the economic downturn. The Council acknowledged that, in this context, the country adopted a policy of further fiscal adjustments and tighter deficit targets to restore investor confidence and noted that this strategy had been backed by international financial assistance from the EU, the IMF and the World Bank[1]. However, the Council also underlined that the planned deficit reduction path was subject to risks, especially since the macroeconomic assumptions underlying the programme had in the meantime become markedly favourable.

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[1] Against the background of increased financial stress, on 4 November 2008, the Council adopted Decision 2009/102/EC (OJ L 37, 6.2.2009, p. 5) to make available to Hungary a medium-term financial loan of up to EUR 6,5 billion under the balance of payments (BoP) facility for Member States. This assistance was provided in conjunction with loans from the IMF of around EUR 12,5 billion supported by a Stand-by arrangement and from the World Bank of EUR 1 billion.

(10) At the time of the October 2006 Article 104(7) recommendation, the official macroeconomic scenario projected an average economic growth of around 3 % annually for the 2007-2009 period. More specifically, for 2009, the scenario was based on the assumption that growth would return to its potential, which was at the time estimated to be at around 4 %. This scenario was considered by the Council at that time to be broadly plausible until 2008 and somewhat optimistic for 2009. In view of the continued strong economic deterioration associated with the financial crisis and the global economic downturn, the Commission services' spring 2009 economic forecast, released on 4 May 2009, projected GDP to contract by 6,3 % and 0,3 % in 2009 and 2010, respectively. Inevitably, this unexpected major adverse economic event, with average GDP growth close to 5 percentage points lower in the 2007-2009 period than expected at the time of the Council recommendation, will bring about large unfavourable budgetary effects. Specifically, taking into account the Commission services' spring 2009 forecast, the associated revenue loss might attain 3 % of GDP in 2010, compared to projections contained in the most recent convergence programme update.

(11) On 29 May 2009, the Hungarian authorities submitted their fifth progress report in the framework of the EDP, which updated the Government's macroeconomic scenario; GDP is now expected to contract by 6¾ % in 2009, with an expected adverse impact on public finance projections of around 1½ % of GDP compared to the February plans. Respecting the revised deficit target of 2,9 % of GDP in 2009 would risk triggering a serious downward spiral of the economy. With the intention of finding an appropriate balance between letting the automatic stabilisers work and containing the revision of the 2009 deficit target to 1 percentage point of GDP (from 2,9 % of GDP to 3,9 % of GDP), the authorities decided to take additional corrective measures of 0,8 % of GDP, while maintaining the full amount of the stability reserves of 0,3 % of GDP. The new strategy of the Government aims to correct the excessive deficit by 2011 through a back-loaded deficit reduction from 3,9 % of GDP in 2009 to 3,8 % in 2010 (in view of the continued recession) and 2,8 % of GDP in 2011. The debt ratio is expected to increase further to around 80 % in 2009, and to over 82 % in 2010, after having increased to 73 % of GDP at the end of 2008 as the first instalments of the international financial assistance from the EU and the IMF (totalling close to EUR 7 billion) were drawn on chiefly to increase reserves. This further increase is mainly explained by the combination of the revaluation of foreign-exchange-denominated debt due to the weaker exchange rate assumption and the lacklustre nominal GDP outlook. For 2011, the report projects a decline in the debt ratio by around 4 % of GDP, which should be supported by the full repayment of first disbursement of the EU loan (implying a debt-reducing stock-flow adjustment of around 2 % of GDP).

(12) Additional corrective measures for 2009 notably include further cuts in pension expenditures, in the housing subsidy systems as well as a further reduction in the public sector wage bill. In order to improve the long-term sustainability of public finances and the growth potential of the economy, the structural reform plans in the areas of pension and social support systems announced in February were strengthened and augmented. Moreover, further consolidation measures were announced for 2010 on the expenditure side, which, among others, include the areas of public sector wage bill and the energy, agricultural and public transport subsidy schemes. On the revenue side, the first phase of the tax reform is expected to be deficit-reducing by around 0,2 % of GDP in 2009. In 2010, the Government plans to continue the tax reform in a broadly revenue-neutral way to reduce the tax wedge on labour, which is, inter alia, to be financed from an increase of consumption and wealth-related taxes. For 2011, the progress report does not fully specify the budgetary measures to achieve the foreseen sizeable expenditure reduction.

(13) According to Article 3(5) of Council Regulation (EC) No 1467/97, if effective action has been taken and unexpected adverse economic events with major unfavourable consequences for government finances occur after the adoption of that recommendation, the Council may decide, on a recommendation from the Commission and before taking into account the relevant factors mentioned in Article 2(3) of Regulation (EC) No 1467/97, to adopt a revised recommendation under Article 104(7).

(14) For Hungary, the October 2006 Article 104(7) recommendation asked for a cumulative structural adjustment of 6½ percentage points of GDP from 2006 to 2009, which translates into an annual structural improvement of close to 2¼ percentage points of GDP while GDP was expected to expand by around 3 % on average. Based on the revised 2009 deficit target of 3,9 % of GDP contained in the progress report, which can be considered plausible in view of the Commission services' spring 2009 forecast and incorporating the most recent economic and budgetary developments, the achieved annual structural adjustment is 8¾ percentage points of GDP over the same period or close to 3 percentage points of GDP on annual average (Commission services' calculations on the basis of the information in the report according to the commonly agreed methodology) against the background of an average GDP decline of 1¾ %. Moreover, the implementation record of the budgetary consolidation measures both on the revenue and the expenditure sides, as well as the structural reform steps adopted since September 2006 including in the area of fiscal governance appears to be good. Overall, given the results of the fiscal adjustment programme since 2006, and specifically, the considerably higher-than-recommended structural adjustment achieved against the background of a much worse macroeconomic environment, the Hungarian authorities can be considered to have taken effective action. On this basis, a revised recommendation for Hungary is justified.

(15) Despite the distinct improvement in Hungary's twin deficits in recent years, the country has remained vulnerable due to the high level of government and external debt. Consequently, the financial crisis had particularly strong adverse effects on the Hungarian economy and led to a sharp exchange rate depreciation and disruption in many segments of the financial markets in autumn 2008, which has since then been partly corrected. In order to foster the credibility of the economic policy, the structural reform programme was strengthened and augmented since the eruption of the crisis, building on the steps made since mid-2006. Following a cumulative 200 basis points rate cut between November 2008 and January 2009 that brought the main policy rate to 9,5 %, the central bank maintained a prudent monetary policy stance as the volatility of the forint and macro-stability considerations limited the scope for further rate cuts. At the same time, new instruments were introduced to support the functioning of the financial intermediaries.

(16) In view of the depth of the unexpected adverse economic events, the target date of 2009 set in the Council recommendation of 2006 can no longer be regarded as realistic. Specifically, further corrective steps in 2009 on top of those decided in the context of the adoption of the 2009 budget, in February and in April 2009 (amounting together to around 2,5 % of GDP), would entail an even more pro-cyclical policy stance, which seriously risks triggering a downward spiral with concerns for economic, financial and structural stability. Moreover, against the projected continuous downturn, the consolidation effort associated with a correction in 2010 could prolong the recession in the light of the adverse effects of additional budgetary measures on aggregate demand. Finally, it should be noted that 2011 is also the target date set in the context of the international assistance of the EU, the IMF and the World Bank. In view of all these exceptional elements as well as of the depth and length of the current recession, the new deadline to put an end to the excessive deficit should be set as 2011. Nevertheless, based on the government's most recent projection of 3,6 % of GDP in 2011 and the resulting structural balance, as calculated according to the commonly agreed method, a lower deficit than the new target of 2,8 % of GDP included in the most recent EDP progress report would be appropriate, in order to ensure the necessary fiscal effort of a cumulative 0,5 percentage points of GDP over 2010 and 2011. Taking into account the exceptional structural improvement achieved since 2006, and especially the planned substantial structural effort of 2½ % of GDP in 2009, this correction would represent an annual average fiscal effort of around 1 % of GDP over the 2009-2011 period.

(17) In general, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy. In the case of Hungary, the correction of the excessive deficit needs to be framed within a comprehensive reform strategy including the continuation of the structural reforms, building on the significant steps achieved since mid-2006 and reinforced since late 2008.

(18) To this end, the Hungarian Government should (i) limit the deterioration of the fiscal position in 2009 by ensuring a rigorous implementation of the adopted and announced corrective measures to respect the target of 3,9 % of GDP, and by allocating possible windfall gains for improving the headline balance; (ii) starting from 2010 (when the deficit should not exceed 3,8 % of GDP), rigorously implement the necessary consolidation measures to ensure a continued reduction of the structural deficit and a renewed decline of the headline deficit, with an increased reliance on structural measures in view of warranting a lasting improvement of public finances; (iii) spell out and adopt in a timely manner the expenditure cuts necessary to achieve the correction of the excessive deficit by 2011 and ensure a cumulative 0,5 percentage points of GDP fiscal effort over 2010 and 2011; (iv) stand ready to seize every opportunity to accelerate the fiscal adjustment, especially as regards 2011; and (v) incorporate sufficient reserve provisions in the forthcoming budget laws to avoid slippages even in the case of unforeseen events. At the same time, the government debt ratio will have to be brought on a firm downward trajectory in line with the multi-annual path for deficit reduction laid down in the progress report and if possible before 2011.

(19) The planned correction of the excessive deficit by 2011 will require the Government to rigorously achieve its budgetary targets which hinges upon an effective implementation of all the consolidation measures announced in the progress report for the years 2009 to 2011 as well as upon timely decisions on and implementation with vigour of further structural reforms and the recently adopted fiscal responsibility law.

(20) Enhanced surveillance under the EDP will require regular and timely monitoring of the progress made in the implementation of the fiscal consolidation strategy. The Commission and the Council shall monitor the implementation of action taken by Hungary in response to this recommendation, in accordance with Article 10 of Regulation (EC) No 1467/97, including on the basis of the continued submission of regular progress reports by the authorities and the information contained in a separate chapter of the Hungarian convergence programme updates.

(21) In general, in the view of the Council, budgetary consolidation measures should secure a lasting improvement in the general government balance, while being geared towards enhancing the quality of the public finances and reinforcing the growth potential of the economy.

HEREBY RECOMMENDS:

1. On the basis of the macroeconomic outlook of the Commission services' spring 2009 forecast, the Hungarian authorities should put an end to the present excessive deficit situation as rapidly as possible and by 2011 at the latest.

2. The Hungarian authorities should reduce the deficit in a credible and sustainable manner. Specifically, to this end, the Hungarian authorities should:

   (a) Limit the deterioration of the fiscal position in 2009 by ensuring a rigorous implementation of the adopted and announced corrective measures to respect the target of 3,9 % of GDP as presented in the most recent EDP progress report, and by allocating possible windfall gains for improving the headline balance;

   (b) Starting from 2010 (when the deficit should not exceed 3,8 % of GDP as foreseen in the EDP progress report), rigorously implement the necessary consolidation measures to ensure a continued reduction of the structural deficit and a renewed decline of the headline deficit, with an increased reliance on structural measures, in view of warranting a lasting improvement of public finances;

(c) Spell out and adopt in a timely manner the consolidation measures necessary to achieve the correction of the excessive deficit by 2011 and ensure, at least, a cumulative 0,5 percentage points of GDP fiscal effort over 2010 and 2011, in light of the significant effort made and effective action taken in 2009.

3. The Council establishes the deadline of 7 January 2010 for the Hungarian authorities to take effective action regarding the measures to achieve the deficit targets for 2009 and 2010. In particular, the envisaged expenditure-reducing measures should be entirely incorporated into the 2010 budget law and be implemented in a timely manner. Moreover, sufficient reserve provisions should be incorporated in the budget law to avoid slippages even in case of unforeseen events. The assessment of effective action will take into account economic developments compared to the economic outlook in the Commission services' spring 2009 forecast.

4. The Hungarian authorities should ensure that the government gross debt ratio is brought onto a firm downward trajectory, in line with the multi-annual path for deficit reduction laid down in the progress report and if possible before 2011. Also against this background, the country should stand ready to seize every opportunity to accelerate the fiscal adjustment, especially as regards 2011.

5. The Hungarian authorities should implement with vigour the recently adopted fiscal responsibility law, including the compliance with the new numerical rules, as well as improve budgetary planning procedures and monitoring of the budget execution with a view to enhancing the medium-term budgetary framework.

In addition, the Council invites the Hungarian authorities to ensure that budgetary consolidation towards its medium-term objective of a structural deficit of ½ of GDP is sustained after the excessive deficit has been corrected.

The Council continues to welcome the commitment of the Hungarian authorities announced originally in the adjusted convergence programme update of 1 September 2006 to submit reports to the Commission and the Council examining progress made in complying with this recommendation on a six-monthly basis. Moreover, it invites the Hungarian authorities to report on progress made in the implementation of these recommendations in a separate chapter in the updates of the convergence programmes until the excessive deficit is corrected.

This recommendation is addressed to the Republic of Hungary.

Done at Brussels,

For the Council
The President